Expert: Taxation of retirement income in need of reform

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Although planning for a comfortable retirement is a mainstay of public discussion, far less attention has been paid to the tax consequences of generating retirement income, says a University of Illinois expert on taxation and retirement benefits.

According to law professor Richard L. Kaplan, the income tax consequences for retirees are varied, outdated or often outright inappropriate.

"Legal and financial analyses abound regarding the various means of saving for retirement and the tax advantages that each option presents, but very few people consider the tax consequences of that income until they're in retirement," said Kaplan, the Peer and Sarah Pedersen Professor at Illinois.

The paper, which was published in the *Virginia Tax Review*, examines the three major sources of retirement income: Social Security, employment-based retirement plans and personal savings.

For each income stream, the article considers how retirement income is generated, sets forth the applicable federal income tax treatment, and proposes reforms to make the pertinent tax rules more sensible, Kaplan said.

"These proposals are intended to remedy the persistent, but hardly benign, neglect that has characterized the taxation of retirement income," he said.

Among the paper's recommendations:

- Simplify how Social Security retirement benefits are taxed.
- Separate defined contribution plan withdrawals into capital gains and ordinary income components.
- Repeal certain exceptions to the early distribution penalty.
- Reduce the delayed distribution penalty and raise the age at which it is triggered.
- Change the residential gain exclusion to avoid unanticipated problems with reverse mortgages.

"The single most significant source of retirement income for older Americans is Social Security, but the taxation of Social Security benefits is far more complicated than it ought to be," Kaplan said. "Why? Because in addition to the progressivity that derives from a graduated income tax, it implements another degree of progressivity. As income increases, it exposes a larger proportion of benefits to taxation, and those amounts are then subjected to rising rates."

Instead, all Social Security benefits should be taxable to the same extent, regardless of whatever other income the recipient reports, Kaplan said.

"All Social Security benefits should be taxable, regardless of the recipient's other income, subject to an exclusion of 12.4 percent to reflect the payroll taxes paid during the person's working life," he said. "Higher-income recipients would still pay more in income tax on their benefits because their income puts them in a higher income tax bracket, but they would not be doubly affected by their non-Social Security income."

Although not as omnipresent as Social Security, employment-based retirement plans like the 401(k) represent a major source of income in retirement. But no matter what type of plan they have, more than 90 percent of retirees withdraw their entire balance in a single lump-sum distribution upon retirement.

A variety of reasons explain that behavior, Kaplan said.

"Some retirees want to sever any remaining connections to a prior employer, while others want more diverse investment options than are available in the former employer's retirement plan," he said. "Still other retirees prefer to buy nonretirement assets such as a second home or a new business, or pay down accumulated debts."

But when a lump-sum distribution is taxed, it should be split into the original investment and the profit components so that the benefit of lower capital gains and dividend taxes can be obtained on the investment profits portion, Kaplan said.

"This is really not that radical a proposal," he said. "Until the Tax Reform Act of 1986, lump-sum distributions were eligible for long-term capital gains treatment on the amount that represented pre-1974 accumulations. And computerized recordkeeping in those days was not as ubiquitous as it is today."

Older adults often have a home that has appreciated in value, but may face a particularly noxious form of "lock-in," making a reverse mortgage to supplement their retirement income less appealing, Kaplan said.

"Some combination of homeowner age and longevity of ownership could entitle the person to exclude all gain upon sale of the home," he said. "In effect, no tax would be due upon the home's disposition if the older homeowner has satisfied the stipulated criteria."

Kaplan said lowering the current exclusion for younger homeowners, or for those whose ownership periods are shorter, could offset the revenue loss from an unlimited gain exclusion for older homeowners while better aligning incentives for long-term homeownership.

More information: The article, "Reforming the Taxation of Retirement Income," is available online. papers.ssrn.com/sol3/papers.cf … ?abstract_id=2240494

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